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Active Equity Managers Stage a Comeback in 2017

By Rich Tavis, CFA®, and Brian Aherns

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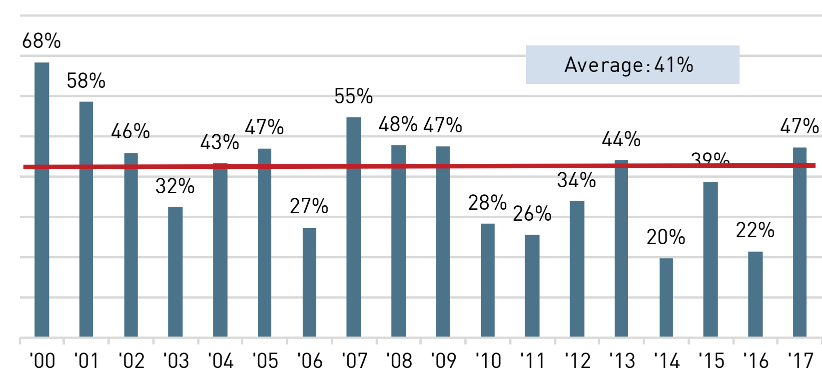
After several years of poor results following the global financial crisis, the performance of large-cap equity managers seems to have turned a corner. In 2017, 47 percent of large-cap equity mutual funds outperformed their benchmarks after fees, the strongest showing since 2009.

Outperformance continued into the first quarter of 2018 with 54 percent of funds outperforming. Is this a head fake, or is the cycle finally starting to turn (see figure 1)?

Figure 1

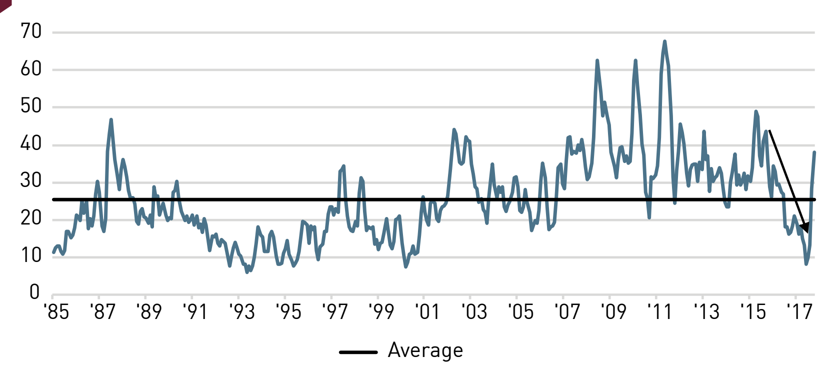
PERCENT OF LARGE-CAP EQUITY FUNDS OUTPERFORMING



Source: Morningstar Direct as of December 31, 2017

Figure 2

S&P 500 INTRASTOCK CORRELATION (ROLLING THREE MONTHS)



Source (as of March 31, 2018): SIRG, S&P, FactSet Research Systems, Inc.

The post-financial-crisis market environment, particularly 2010 to 2016, was especially difficult for large-cap equity managers. Some of the factors that we observed weighing on performance include the following:

The traditional active management playbook wasn't working: Market prices were driven by macroeconomic news rather than company-specific fundamentals.

Portfolio construction biases created headwinds: Holding any cash or non-U.S. equities resulted in a drag on performance. The S&P 500 gained more than 12 percent on an annualized basis, outperforming non-U.S. stocks by more than 9 percent.

A low-volatility environment limited active managers' opportunity set: Quantitative easing by global central banks compressed market volatility. Less alpha was up for grabs because the spread between the best- and worst-performing stocks in the market was lower than normal.

As we wrote in our February 2017 paper, "Is the Tide Turning for Active Management?"[1], we don't believe these factors are a permanent feature of the investment landscape. Rather, we think they were symptoms of unprecedented central bank intervention in markets following the global financial crisis.

Although not all the headwinds have calmed, the environment for active investing appears to be headed in the right direction from several perspectives.

First, stock prices started moving in response to company-specific fundamentals again. One metric we follow is the intrastock correlation of S&P 500 stock returns. When intrastock correlations are high, stock prices are all moving together, presumably in response to macroeconomic news. When correlations are low, it implies that stocks are moving more independently, in response to company-specific factors. Intrastock correlations remained elevated through the global financial crisis, but they fell below pre-crisis levels in 2017 (see figure 2). Intrastock correlations are likely to spike in response to macro events. For example, they did increase with equity market volatility in February and March 2018. While it remains to be seen how the rest of the year plays out, we don't believe that a high correlation environment is likely to be sustained for an extended period of time given the shift in market environment.

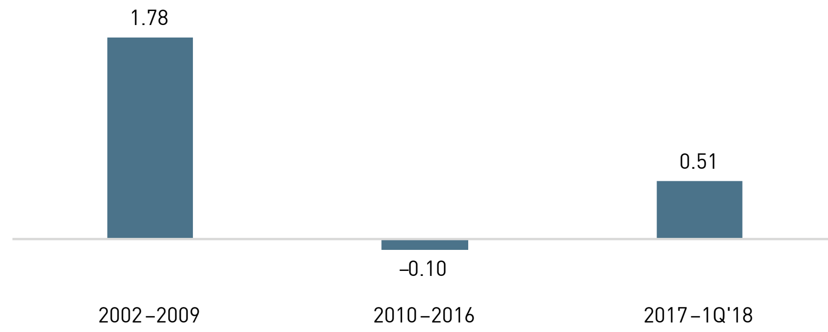
We also monitor how stock prices have been responding to corporate earnings announcements. Figure 3 shows the difference in performance between stocks with the biggest positive earnings surprises (top quintile) and stocks with the biggest negative earnings surprises (bottom quintile) for the month following an earnings announcement. Historically, investors have been rewarded for forecasting earnings better than the market—quintile one stocks outperform quintile five. From 2010 to 2016 (the post-crisis environment), this wasn't the case. Investors weren't getting paid for superior forecasting ability. However, the tide appears to be turning. Since 2016, earnings have started to matter again.

A second factor we observed was that certain portfolio construction biases found in active-manager portfolios led to headwinds in the post-financial-crisis environment—2010 through 2016 (see table 1). We estimate that the roughly 2-percent cash position that is typical for an active strategy has resulted in 20–23 basis points (bps) of underperformance on an annualized basis. The 4–4.5-percent average allocation to non-U.S. stocks has cost between 26–46 bps on an annualized basis. Non-U.S. exposure hasn't been a headwind more recently. Growth managers, in particular, have benefitted from exposure to a handful of high growth companies in China. Furthermore, we don't believe that the headwinds managers faced in the post-crisis environment are likely to reassert themselves in the near future.

The Strategic Investment Research Group (SIRG) Investment Manager Survey[1] is a quarterly survey of investment managers that gauges sentiment regarding the economy, financial markets, and key risks to investment portfolios. We asked participating firms

Figure 3

AVERAGE ONE-MONTH STOCK RETURN AFTER EARNINGS ANNOUNCEMENT BIGGEST BEATS (TOP QUINTILE) VS. BIGGEST MISSES (BOTTOM QUINTILE)



Source (as of March 31, 2018): SIRG, FactSet Research Systems, Inc.

Table 1

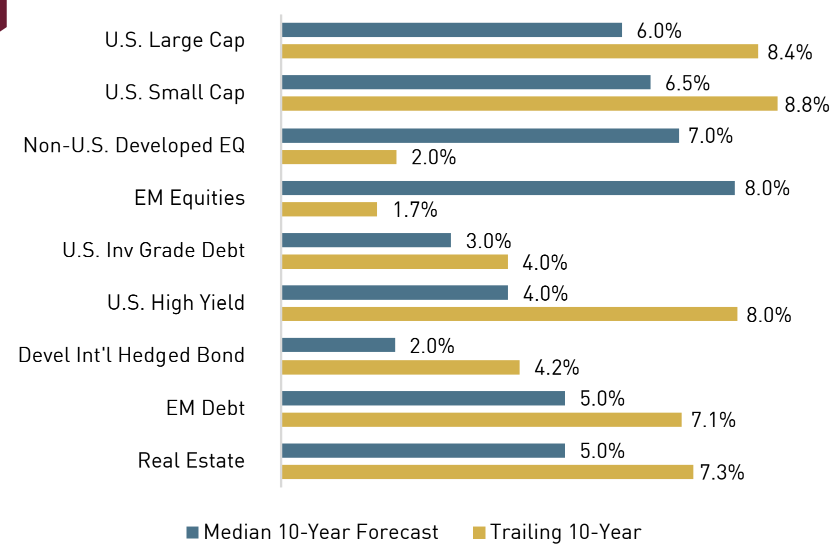
IMPACT FROM PORTFOLIO CONSTRUCTION HEADWINDS

	2017–1Q 2018			2010–2016		
	Large Growth	Large Blend	Large Value	Large Growth	Large Blend	Large Value
Impact of Cash Drag	–0.10	–0.10	–0.10	–0.20	–0.21	–0.23
Impact of Non-U.S. Exposure	0.99	–0.02	0.23	–0.46	–0.43	–0.26
Total	**0.89**	**–0.12**	**0.13**	**–0.66**	**–0.64**	**–0.49**

Source (as of March 31, 2018): SIRG, Lipper, Russell, FactSet Research Systems, Inc.

Figure 4

10-YEAR RETURN EXPECTATIONS



Source: Median 10-Year Forecasts are from the January 2018 SIRG Investment Manager Survey. Trailing 10-year asset class returns are as of March 31, 2018 to provide longer-term (10-year) return estimates for major asset classes and compared the forecasts to historical 10-year returns (see figure 4).

After extremely strong performance in recent years, U.S. stocks have gotten more expensive, resulting in lower return expectations. One implication is that the impact of cash drag on active portfolios is likely to be less pronounced in the coming years. Furthermore, although return expectations for U.S. stocks have fallen, assumptions for non-U.S. and emerging-market equities are higher than investors have experienced in recent years, indicating that the negative impact from holding non-U.S. stocks may be behind us.

One headwind that remained in 2017 is that the low-volatility environment continued to limit the opportunity set for bottom-up stock pickers. Stock price dispersion, the spread between the best- and worst-performing stocks, is one way to measure potential value added from stock selection. After all, active managers attempt to overweight the best performers and underweight or avoid the worst-performing stocks. The low-volatility environment was particularly challenging from about mid-2012, when the U.S. Federal Reserve first announced its second round of quantitative easing, until mid-2015, when markets started pricing the first rate hike by the Fed. In this environment, the spread between the best- and worst-performing large-cap equity managers was also smaller than normal. That dynamic resurfaced in 2017, as markets focused on strong economic and earnings growth due to policy uncertainty in Washington and escalating tensions with North Korea (see figure 5).

In early 2018, volatility started to pick up. In February, a combination of technical factors and jitters over inflation and rising interest rates drove a market sell-off. More recently, concerns about trade policy have impacted markets. Against this backdrop, cross-sectional volatility has increased to more-normal levels.

As noted, the performance for large-cap equity managers first started to improve during the summer of 2016. Going into the period, many of the largest overweight positions in large-cap managers' portfolios were in the technology and financial sectors, and the largest underweights were in lower volatility/higher

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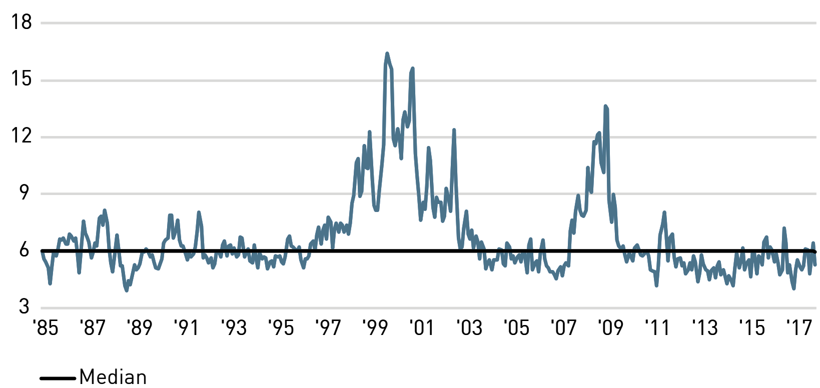
Figure 5

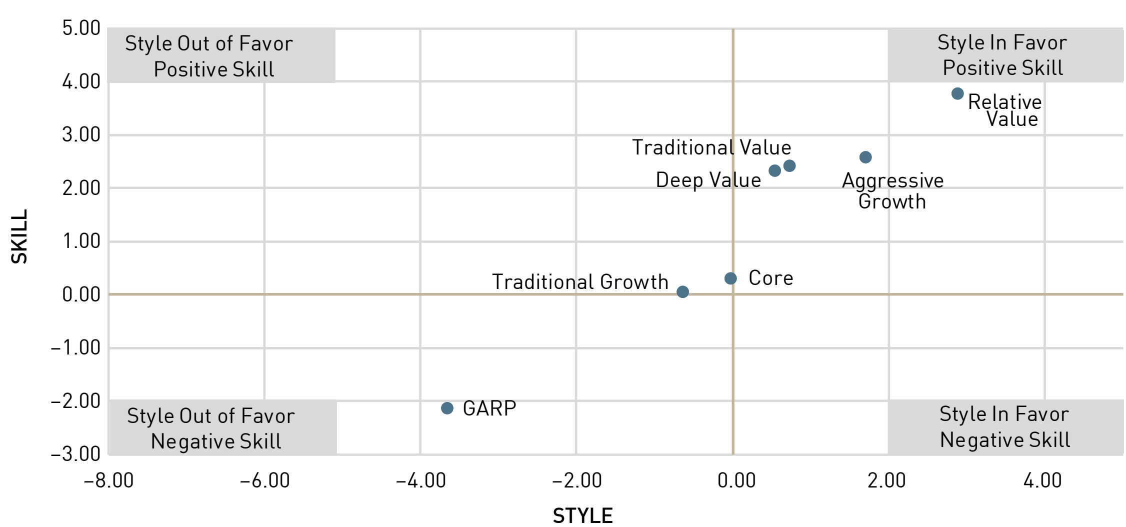
MONTHLY CROSS-SECTIONAL VOLATILITY BETWEEN S&P STOCKS



Source (as of March 31, 2018): SIRG, FactSet Research Systems, S&P

Figure 6

SKILL VS. STYLE, TRAILING ONE-YEAR



Source (as of March 31, 2018): SIRG, Morningstar Direct, MSCI Barra, Russell. Skill is defined as contribution to excess performance from stock selection and industry exposures. Style is defined as contribution to excess performance from style factors.

ACTIVE EQUITY MANAGERS

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dividend yield sectors such as utilities and consumer staples.

With increasing inflation expectations at the start of 2016, managers benefitted from positions in financials and underweights to bond proxies. This trend gained further momentum following the U.S. presidential election, given expectations for a more reflationary policy mix. When the reflation trade started to lose some steam in mid-2017, managers benefitted from outperformance of technology stocks, in particular the so-called FAANG stocks, the five top-performing tech stocks Facebook, Apple, Amazon, Netflix, and Alphabet's Google.

These growthier exposures have indeed been a tailwind to performance for aggressive-growth managers and value-oriented managers when measured against value benchmarks (see figure 6). The opposite was true for growth-at-a-reasonable price (GARP) managers, for example, who had less of those exposures relative to growth-oriented market indexes. It hasn't, however, been the sole driver of relative results. Our analysis also indicates that large-cap equity managers generally experienced a positive impact from what we would consider skill—stock selection and industry tilts, over the past year (ending March 31, 2018).

Taken together, the environment for active managers seems to be as healthy as we've seen since 2010. Unlike prior shorter-lived periods of strength, recent performance doesn't seem to be driven by a single factor. As markets continue to rise, investors have gotten increasingly less comfortable with elevated valuations and are questioning how much longer the current economic expansion has left to run. Given where valuations and fundamentals are today, the market environment over the next several years is likely to be very different than the one investors have experienced since 2010. With elevated equity valuations, fundamentals are likely to be the primary driver of returns. Active management can have an important role to play in what we believe will be a challenging investment environment over the next several years.

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ENDNOTE

1. "Is the Tide Starting to Turn for Active Managers" and the SIRG Investment Manager Survey can be found at http://prusirg.prudential.com/aspx/Home.aspx.

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